Pinehurst Condominium Association
Reserve Planning and Capital Policy
March, 2023

History. Pinehurst Incorporated, d/b/a Pinehurst Condominium Association established its first capital reserve in 2010. Owners were assessed to create a reserve to provide funds for emergencies. Prior to this date the HOA provided for day-to-day cash flow needs solely from monthly maintenance fees. Special assessments were levied by the board infrequently but with little notice, for example to cover an operating deficit due to unexpected snow removal costs and fund a significant repair of 8 of the 9 building roofs. In recent years separate accounts were used to maintain funds designated for Operating, Reserve and Roof Reserve. Due to a fire in building seven and payments received under the insurance trustee provisions of the Declarations, a fourth account was maintained for Reconstruction until the funds were depleted.

Current Status. The policy of the association has been to set aside 10% of annual maintenance fees to be deposited into the Reserve Account. The intent of this transfer was to primarily meet FHA standards to assist first time buyers in qualifying for advantaged borrowing terms and to maintain adequate funds to meet emergencies and unbudgeted needs for property maintenance. The capital contribution was *not* explicitly tied to the predictable costs of replacing long-term reserve elements such as roofs, exteriors, subsurface utilities, or roads.

Rationale for Policy. The association recently updated its reserve study in 2022 through an independent assessment of the common reserve elements using an outside firm's engineers and construction cost projections. The board has also identified a near term need to repair the exteriors of the buildings, a requirement included in the latest study and financial projections from Reserve Advisors.

The study identified short term needs to conduct non-recurring maintenance of the asphalt surfaces (crack filling and sealing) and longer-term to fund surface milling and overlay of the asphalt surfaces (in 5 years), roof replacement (in 12 years) and a total replacement of asphalt (in 25 years). Additionally, the capital contribution should vary based on lifespan of exterior materials chosen (plywood versus vinyl versus fiber cement) and identified costs for proper maintenance of the stucco surfaces, currently out of scope in the siding project. The board has also engaged outside counsel to review the Declarations to bring them up to date with existing best practices and prevailing law.

Therefore, the objectives of this policy are to:

- Clarify financial controls on how reserve funds are used, setting forth policies for how such funds will be accounted for, where they are deposited, and how used on behalf of owners.
- Ensure current owners pay a fair share of future obligations by spreading out capital requirements over 10-15 years or more.
- Base annual capital contributions on an independent assessment of future replacement costs, ensuring resources are sufficient but not excessive and comply with applicable IRS rules for reserve funding, e.g. ASC606.
- Provide a modest cash on hand buffer to provide for fluctuations in working capital or cover emergencies, thereby reducing the risk of future special assessments that impair homeowners budgeting for upkeep.

Definitions.

- *Operating/Maintenance Items (Non Capital/Non Reserve Elements)*. Funds collected and used for on-going maintenance items. The primary source of funds is from monthly maintenance fees. Under IRS regulations, for example, painting existing siding and repairing cracks and resealing pavement must fall within the operating account.

- *General Reserve Account*. This account has sourced funding from an annual transfer from the operating account, or a special assessment in the event it becomes depleted and is intended to provide emergency reserves for operating account deficits. Going forward, the annual maintenance fee should include an annual capital contribution based on the reserve study. It may be funded through special assessments but preferably should be funded from additional fees collected from owners annually within their monthly maintenance fees, otherwise known as a stable annual reserve contribution rate, over 20-30 years. This account falls under the definition in the Declarations for general reserves. The savings rate for general reserve contributions should be published as part of the annual budgeting process.

- *Special Reserve Account(s)*. Reserve account(s) are established and used according to the requirements of the Declarations for specific purposes identified by the long-term reserve study. Resolutions for approval of spending to cover special reserve elements should define the precise materials and installation; projects spanning over multiple years should restrict departures from scope to ensure uniformity of designs and ensure equitable impact on property values across all units.

<u>RESOLVED:</u>

1. Maintenance of existing common elements will be funded from the operating account and shall include items expected to be funded yearly and preferably with fees set forth in vendor agreements. The operating account shall not be used to replace long-term reserve elements. Funding of the operating account should set fees to equal planned expenditures without a meaningful surplus.

2. In the event operating costs exceed the original or amended budget or any carry-over surplus, the board shall either adjust the annual reserve contribution downward temporarily or adjust maintenance fees or reserve contribution in a future year. The property manager acting as agent shall have the authority to use general reserve funds to meet association obligations.

3. The use of special assessments should be avoided, used as a last resort, and limited to maintaining adequate working capital to meet unexpected and significant budget variances that impair the long-term general reserve targets. Consistent with past precedent and the authority granted it under the Declaration of Unit Ownership, special assessments must be approved by a majority of council meeting in a properly noticed meeting with a quorum present.

4. The annual budget will comprise two types of fees, those for maintenance and upkeep, and separate accounting for planned spending for non-recurring items and reserve spending. Owners will be assessed two monthly fees, for operating expenses and reserve contributions, combined so owners' single monthly payment covers both fees.

5. Reserve funds shall be used to pay for the replacement of a reserve component or asset that is already in existence. General reserve contributions made via a monthly contribution and set within the annual budgeting process should be determined based on a long-term, professional prepared Reserve Study. The target funding level should be 70-100% of long-term requirements identified in the reserve study. Use of reserve funds is subject to the requirements set forth in the Declaration of Unit Ownership and the Code and Regulations.

6. The Reserve Study should be updated at least every five years, ideally every 3, using a qualified independent firm, for example Reserve Advisors. Owners shall receive a copy of the study. Reserve funds should not be used to alter or improve the existing common elements but rather fund long-term upkeep and replacement requirements. Permissible items include new roofs and roads but excludes additions to buildings, land

improvements, or constructing new structures unless the Declaration and Code of Regulations give Council such authority.

7. The annual budgeting process should adopt the latest best practice and statutory guidance under the Uniform Condominium Act (found at Pa. C. S. Title 68 §3303), which supersedes the original Declaration of Unit Ownership under the Unit Property Act. Council shall publish an annual budget identifying recurring maintenance needs, non-recurring cost items, planned capital expenditures, and a stable capital contribution rate set based on funding targets set by the board.

8. Once approved by Council and published, owners shall have 30 days to submit a written objection to the Council Secretary, sent in care of the property manager to the business address of the association. Unless a majority of owners object to the proposal, in which case the previous budget shall prevail, the initial budget or subsequent amendments are considered ratified.

9. The budget should also include forward looking non-binding projections of at least 3 years. Resale certificates issued to potential buyers shall meet current disclosure requirements and this obligation is delegated to the property manager.

ADOPTED THIS 9 TH DAY of MARCH 2023.

Council President

Council Secretary (Acting)

Witnesses

Addendum: Statement of Financial Controls

The association through its governing documents and management agreement with its property manager has established financial controls to ensure accounting mistakes are not incorporated into the financial statements, to prevent fraud or misappropriation of funds, and to have records of financial condition that are comparable from year to year.

- The association uses GAAP standards using the accrual method of accounting for revenue and expenses based on calendar year fiscal reporting. The association uses a third party to prepare an income statement, balance sheet and cash flow reconciliation monthly and for the completed fiscal year.

- The property manager provides a controller and tax officer to prepare financial reports and file all tax returns in the applicable jurisdictions. The association maintains fidelity insurance to protect itself from fraud or theft.

- Cash and other assets such as certificates of deposit are required to be kept in FDIC insured accounts whose access to the funds is restricted to its agents in the property manager firm. Directors and owners are not permitted access to these accounts and do not sign or issue checks. Operating and reserve funds are kept in segregated accounts.

- The controller and Treasurer shall reconcile accounts regularly, comparing internal cash books with external bank statements. Monthly financial statements of the operating and reserve accounts, showing receipts and uses, shall be distributed to all owners. Deposits shall be maintained in segregated accounts for use against operating expenses, general reserves, and special reserves.

- The association hires a third-party accounting firm to review the books maintained by the property manager on behalf of the association. The CPA reviews the general ledger to ensure proper classification of transactions and consistently applied GAAP standards. The independent financial review records the relevant management representations and provides a limited assurance of reliable and comparable presentations of the financial condition of the association.

- Once completed, the financial statements prepared by the association's independent accounting firm will serve as the official record and supplant interim statements of financial condition prepared by the property manager.

- The major vendors of the association provide written scopes of work and a statement of their fees, whose services are reviewed and approved by council. Payments made to vendors are made by the property manager, who checks the invoice against the contractor's fee schedule or other details provided by utilities.

- One person or entity shall not have the ability to initiate, approve and review transactions. The Council shall initiate transactions because it approves contracts, for landscaping and snow removal. The property manager shall review and authenticate invoices and ensure that they are paid and recorded in the general ledger in a timely manner.

- The association segregates roles such that the property manager proposes the draft budget, pays invoices and manages an agency bank account, while the council approves the budget and vendor selection as well as reviews significant disbursements before the property manager issues the checks (usually for major reserve and non-recurring uses of funds). The practice of the council has been to ensure at least two council members, if not all the directors, review major transactions involving the reserve accounts.